No. [redacted] 44

In the

Supreme Court of the United States

OCTOBER TERM 1965

GERALD SEGAL, Individually and d/b/a SEGAL COTTON PRODUCTS, et al.,
Petitioners,

v.

WILLIAM J. ROCHELLE, JR., Trustee,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENT

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OPINION BELOW, JURISDICTION AND STATUTE INVOLVED

Petitioners' brief correctly cites the opinion below and correctly states the grounds on which jurisdiction of this Court is invoked.

At page 2 of Petitioners' Brief, in the last line of the quotation of Section 70a of the Bankruptcy Act, the word "ceased" should read "seized."

QUESTION PRESENTED

The question presented by this case was correctly stated by the Court below (R23) as "* * * whether loss-carry back refunds forthcoming under the federal income tax statutes (Section 172 of the Internal Revenue Code of 1954, 26 U.S.C.A. § 172) and arising from losses sustained prior to but in the year of bankruptcy go to creditors or the bankrupt."

This case does *not* involve rights to refunds in any taxable year after the year of bankruptcy.

This case does *not* involve business losses incurred after the date of bankruptcy.

This case does *not* involve the right to carry *forward* operating losses.

STATEMENT OF THE CASE

Petitioners' statement of the case is correct.

But to make it clear that this case is not complicated by the fact that there were post-bankruptcy operating losses in the year of bankruptcy, and that all operating losses giving rise to the refund were incurred between January 1, 1961, and September 27, 1961 (the date of bankruptcy), a portion of the fact stipulation is here quoted (R13):

> "The losses giving rise to the refund were incurred by the partnership * * * and * * * the net losses carried back were arrived at by deducting from the partnership losses which were incurred between * * * January 1, 1961 to September 27, 1961, the income of the individual bankrupts earned during the calendar year 1961 from sources other than the partnership * * * The various

claims for refund * * * were therefore predicated and based on the entire calendar year 1961."

SUMMARY OF RESPONDENT'S ARGUMENT

Congress intended to secure to creditors all non-exempt property of a bankrupt. The right to an operating loss-carryback refund is transferable property within the meaning of Section 70a(5) of the Bankruptcy Act. That the right is contingent and its realization postponed until the end of the calendar year does not prevent the right from being a "possibility coupled with an interest," which this Court has held to be "property." The right is transferable and its transferability is not affected by the Assignment of Claims Act, which Act has no applicability either to transfers by operation of law or to the validity, as between the parties, of assignments of claims against the Government.

An opposite result to that reached by the Court below would result in an unjustifiable windfall to the bankrupt at the expense of his creditors, and would encourage those contemplating bankruptcy to increase their losses so as to build up the amount of the refund.

ARGUMENT

Petitioners argue that the wording of Section 70a(5) does not expressly include a loss carry-back refund and, therefore, the statute should not be held to include such a cause of action.

But every statute must be interpreted in light of its purpose. *Martin v. National Surety Co.*, 300 U.S. 588, (1937).

Applicable statutes should be broadly construed if such a construction is necessary to carry out clear Congressional intent. *In Re Cantelo Mfg. Co.*, 185 F. 276 (D.C. Me., 1911).

Bankruptcy Courts are courts of equity and should exercise equitable powers to the end that substance will not give way to form, and that technical considerations will not prevent substantial justice from being done. *Pepper v. Litton*, 308 U.S. 295 (1939).

As pointed out by the court below in its opinion, the section in question was originally enacted in 1898 and reenacted, with modifications, in 1938, and loss carry-back refunds did not come into existence until 1942. However, in *Chandler v. Nathans*, 6 F. 2d 725 (3rd Cir. 1925), the Circuit Court of Appeals held that the right to the tax refund, which right was only created by Congress in 1918, nevertheless passed to the trustee under the Bankruptcy statute enacted in 1898.

It is fairly arguable that Congress never intended specifically to list and describe every conceivable property right which passes to the trustee in bankruptcy. Section 70a(5) is couched in broad language, and purposely so, in order that it may include rights which are created from time to time by statutes, economic developments, or otherwise. Congress merely prescribed certains tests to be applied—namely, susceptibility to transfer—to determine whether a given property right passed to the trustee.

Collier on Bankruptcy says:

> "Section 70a(5) is extremely broad and searching, and has been drawn 'to comprise all property that the bankrupt may have that may be of use or benefit to him, however small.' It includes every vested right and interest growing out of property that can properly be the subject of lawful transfer, levy or seizure—whether it be corporeal or incorporeal." Collier, Vol. 4, Sec. 70.15.

The Right is "Property"

It cannot be argued that the taxpayer's right to a net operating loss carry-back refund is not a vested statutory right. Indeed, the statute (26 U.S.C.A., Section 172, 68 A Stat. 63) begins with the words, "there shall be allowed * * *" This right cannot be characterized as the mere possibility of a gratuity.

Admittedly, the realization of the right must be postponed until the end of the taxable year when the entire loss picture may be viewed and, in this case, on September 27, 1961, the amount of refund which the government would be obligated to pay was rendered uncertain by reason of the possibility of earnings or further losses by the bankrupts after the date of bankruptcy and prior to the end of the taxable year. The court below dealt with this problem as follows: (R33)

> "A proration of the refund in the ratio of the losses before and after the filing date would be indicated in the event of losses after the filing date. Earnings after the filing date would simply reduce the amount of the refund to the trustee * * *"

But that the right to realization was postponed could not affect its status as "property." Otherwise, a note receivable

would not pass to the trustee because it was not due on the date of bankruptcy. That the amount of the refund was uncertain would not destroy the character of the right as "property." Otherwise, the bankrupt's right of action for damages to property would not pass to the trustee because the exact amount of the damages had not been, yet, judicially determined.

There are many cases in which contingent rights have been held to pass to the trustee. One of the leading cases is *Williams v. Heard*, 140 U.S. 529 (1891), where the bankrupt had a claim for the recovery of extra war risk insurance premiums paid during the Civil War. On the date of bankruptcy, in 1875, Congress had not even provided for a recovery, much less made an award. The award was not made until 1886. Nevertheless, the Supreme Court held that the contingent claim of the bankrupt passed to the trustee in 1875.

In Re Dorgan's Estate, 237 F. 507 (D.C.S.D. Iowa, 1916), was quoted by the court below as an instance where a remainder, subject to divestment, was held to pass to the trustee, even though contingent and subject to being entirely defeated.

Horton v. Moore, 110 F. 2d 189 at 191 (6th Cir., 1940), held that a contingent interest, subject to being defeated by the bankrupt's predeceasing his mother, passed to the trustee because it was "property and capable of being alienated * * *" The Court continued: "The fact that the trustee * * * could not get any portion of the corpus of the trust

estate until some future time or on the happening of a contingency be deprived of it, is not under the Statute fatal to the passing of title to [the trustee.]"

These cases involving contingent remainders are entirely analogous to the case at bar.

Kleinschmidt v. Schroeter, 94 F. 2d 707 (9th Cir., 1938), cited by the court below, is another instance of a conditional right which was held to pass. Here a joint adventurer, who had forfeited all interest in the venture except the conditional right to return of prior contributions in event of the profitable sale of the mine, became bankrupt. Such conditional right vested in the trustee.

The Right is Transferable

Section 70a(5) also requires that the right be transferable by the bankrupt. What is transferable is a question of state law. *Spindle v. Shreve*, 111 U.S. 542 (1884). The Referee, in his well-considered opinion (R 6, 19) pointed out that, under Texas law, a contingent claim is transferable by assignment and cited *Moser v. Tucker*, 26 S.W. 1044 (S.C. Tex., 1894) and *Wheeler v. Riviere*, 49 S.W. 697 (C.C.A. Tex., 1899).

As long ago as 1828, this Court, in *Comegys v. Vasse*, 26 U.S. (1 Peters) 193, (1828), held that "* * * possibilities coupled with an interest * * * may pass by assignment," and thus pass to a trustee in bankruptcy. In that case, a claim for indemnity against a foreign government, totally unenforceable at the date of bankruptcy, nevertheless passed to the trustee, since it was such a right as would pass to the

bankrupt's administrator at death. Many cases followed the *Comegys* ruling, and applied the "passing at death" test. But since the statutory language of the Act of 1800 has undergone considerable change, we do not now urge that the "passing at death" test be applied to the case at bar.

Cases Relied on by Petitioners

The Petitioners rely on *In Re Sussman*, 289 F. 2d 77 (3rd Cir., 1961), and *Fournier v. Rosenblum*, 318 F. 2d 525 (1st Cir., 1963). The court below had the benefit of both of these decisions but declined to follow them. In *Sussman*, the Third Circuit admitted, at page 78, "Perhaps this June expectation that a right to a refund would arise six or seven months later can be described as a contingent claim against the United States," but went on to hold that such a right was, nevertheless, non-assignable under the Assignment of Claims Act, 31 U.S.C., Section 203. Apparently, the Third Circuit, in making this decision, which the Court itself appeared to think regrettable, was not cited to the many cases including *Erwin v. U. S.*, 97 U.S. 392 (1878), and *U. S. v. Gillis*, 95 U.S. 407 (1877), holding that the Anti-Assignment Act has no application to assignments by operation of law, and does not affect the validity of such assignments as between the parties. The First Circuit, in *Fournier*, did not bottom its decision on the Assignment of Claims Act, but stiffly followed the *Sussman* decision on grounds of stare decisis.

In the *Fournier* decision, the only case cited was *Sussman*. No mention was made of *Williams v. Heard*, *Comegys v. Vasse*, *Horton v. Moore*, *Dorgan's Estate*, or *Kleinschmidt v.*

Schroeter, and presumably they were not considered, since had they been considered, such authority would at least have required discussion and might have brought about a contrary result.

Sussman and *Fournier* inspired well justified criticism in articles such as those in the *Journal of the National Association of Referees in Bankruptcy*, Vol. 36, p. 18 (January 1962) by Hon. Asa Herzog, 14 *Stanford Law Review* 380, and 40 *Texas Law Review*, p. 569.

Petitioners also cite *Harlan v. Archer*, 79 F. 2d 673 (4th Cir., 1935) as authority for the proposition that a mere "possibility" does not pass to the trustee. This case is inapplicable because the bankrupt had no "right", as do the bankrupts in the case at bar, and had only the hope of a gratuity from the government. The bankrupt, in *Harlan*, owned a cannery in Maryland. The government, during World War I, condemned farms in the area and forced the bankrupt out of business because no farms remained in the area on which tomatoes were raised to be canned in the bankrupt's plant. Therefore the damages sought were consequential only and not direct, and characterized by the court as a "mere expectancy, a claim founded on no legal right known to courts of law or equity, a claim which is but an appeal to the clemency of Congress to the redress of an injury, where there is no obligation on the part of the government, and the granting of relief is purely a matter of legislative discretion, cannot be regarded as property, and does not

pass in bankruptcy." In the case at bar, on the other hand, the refund is based on a right established by statute, and there is a positive legal obligation on the part of the government to make the refund; the granting of relief involves no discretion and no element of gratuity. The annotation following the report of the *Harlan* decision in 102 A.L.R. at page 159, cites many cases where contingent claims have been held to pass to the trustee, including claims for tax refunds.

Petitioners cite *In Re Prince*, 43 F. Supp. 592 (D.C. S.D.N.Y., 1942) for the proposition that a bankrupt's commissions as testamentary trustee, which have not yet been allowed and are not yet payable, do not pass to the trustee in bankruptcy. But this case relied on *In Re Furness*, 75 F. 2d 965 (2d Cir., 1935) which held that it was settled law in the State of New York that an attempt to assign unascertained and unliquidated commissions as a testamentary trustee was against public policy. There is no suggestion of any such limitation imposed by Texas law concerning the facts in the case at bar. *Furness* also pointed out that the amount of fees, if any, would ultimately depend on the executor's proper accounting, approved by the court, which accounting had yet to be done.

Petitioners also rely on *In Re McManaman*, 50 F. Supp. 869 (D.C.N.D. Ill., 1941) involving the trustee's right to an employee's interest in a retirement fund. This case correctly held that, since the employee-bankrupt had no rights in the retirement fund until he either died or resigned, the

Bankruptcy Court had no jurisdiction to order him to quit his job to enable the trustee to take over the interest in the fund. But the factual distinction between *McManaman* and the case at bar is obvious.

Practical Effect of Adoption of Rule of *Sussman* and *Fournier*

As admitted by the Third Circuit in *Sussman*, and by the First Circuit in *Fournier*, the result of those cases was a windfall to the bankrupt at the expense of his creditors.

It should also be pointed out that the adoption by this Court of the rule in *Sussman* and *Fournier* would have the practical effect of encouraging those contemplating bankruptcy to increase their losses so as to build up the amount of the refund with which they would go forth, discharged of their debts. This would open the gates to all manner of mischief, such as the employment of relatives at high salaries, sales far below cost, or any other device which would have the result of increasing operating losses at the expense of creditors with resultant unjust enrichment of the bankrupt.

Petitioners argue that the affirmance of the court below would cause bankrupt estates to be administered over many years so as to take advantage of the loss carry-*forward*. This argument is without merit. The trustee here does not contend that the estate is entitled to any portion of an operating loss carry forward, and the realization of the rights to the loss carry-back refund will not delay the administration of bankrupt estates.

Conclusion

For the reasons stated, it is respectfully submitted that the judgment of the court below should be affirmed.

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I, the undersigned counsel of record for respondent herein, hereby certify that on this .... day of September, 1965, service of a copy of this brief was accomplished on Henry Klepak, Esq., Counsel for the Petitioners, by placing a copy of this brief in a United States mail box, first class postage prepaid, addressed to said counsel at 1509 Mercantile Bank Building, Dallas, Texas.

Counsel for Respondent